

Internal Revenue Service

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Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:ITA:B05

PLR-132561-11

Date:

September 20, 2011

LEGEND

Taxpayer =
Holding Corp =
Acquisition Corp I =
Acquisition Corp II =
Acquisition Corp III =
Defendant =
Target =
Target Sub =
Other Target Assets =

Year 0 =
Year 1 =
Year 3 =
Year 5 =
Month a =
Month b =
Month c =
Month d =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Trial Court =

Appellate Court =
\$X =
\$Y =
\$Z =

Findings of Fact =

Dear :

This responds to your letter dated July 29, 2011, requesting a ruling that Taxpayer's recovery of damages from Defendant should be treated as a nontaxable return of capital.

FACTS AND REPRESENTATIONS:

In Year 0, Target, a unit investment trust, decided to sell its assets and invited bids from potential buyers. In Month a of Year 1, Taxpayer entered into a binding agreement with Target to purchase Target's assets. Under the agreement, Taxpayer was to acquire the assets of Target, net of liabilities and certain expenses, based on a valuation of all outstanding Target units at \$X per unit, reflecting a substantial premium over the trading price for the units. Unitholder approval of the transaction was expected in Month c of Year 1.

In Month b of Year 1, Defendant interfered with Taxpayer's agreement to purchase Target's assets. As a result, Target's unitholders did not approve the transaction and Taxpayer was unable to complete the purchase for the price set forth in the original agreement. On Date 1 of Year 1, Taxpayer agreed to an amendment to its original purchase agreement to increase the valuation of Target from \$X to \$Y per unit, representing a total price increase of \$Z. On Date 2 of Year 1, following Target unitholder approval, Taxpayer, through its wholly-owned entities, closed on the purchase of Target's assets at the increased price.

Taxpayer financed the purchase of Target's assets by contributing capital to three wholly-owned entities, Holding Corp, Acquisition Corp II and Acquisition Corp III. Acquisition Corp I, a wholly-owned subsidiary of Holding Corp, acquired the assets of Target Sub and Acquisition Corp II and Acquisition Corp III acquired the Other Target Assets.

In Month d of Year 1, Taxpayer filed a complaint against Defendant in the Trial Court, asserting state law claims for tortious interference. The Trial Court determined that: Findings of Fact. On Date 3 of Year 3, the Trial Court awarded damages of \$Z, the amount of the price increase that Acquisition Corp 1, Acquisition Corp II and Acquisition Corp III paid for Target Sub and Target's Other Assets following Defendant's interference with Taxpayer's original agreement. On Date 4 of Year 5, the Appellate Court affirmed the Trial Court's award of damages to Taxpayer.

Taxpayer has asked for a ruling that its recovery of damages from Defendant represents a nontaxable return of capital to the extent of its adjusted basis in Holding Corp, Acquisition Corp II and Acquisition Corp III.

Taxpayer represents that, in reducing the adjusted bases of Holding Corp, Acquisition Corp II and Acquisition Corp III, it will allocate the \$Z judgment between the three entities based on the relative amount of the capital contribution that it made to each to finance the purchase of Target Sub and Target's Other Assets.

LAW AND ANALYSIS:

In determining how litigation recoveries should be taxed, the relevant question is "in lieu of what were the damages awarded"? *Raytheon Production Co. v. Commissioner*, 144 F.2d 110 (1st Cir. 1944), *cert. denied*, 323 U.S. 779 (1944). When a court has entered a judgment for the taxpayer, the tax treatment of the taxpayer's recovery can be determined based on the taxpayer's complaint and issues and evidence presented to the jury. See, e.g., *State Fish Co. v. Commissioner*, 48 T.C. 465 (1967), *modified by* 49 T.C. 13 (1967), *acq.* 1968-2 C.B. 1. To the extent a recovery compensates for injury or loss to a taxpayer's property, it is considered to represent a restoration of capital to the extent of the taxpayer's capital interest. See § 3.01 of Rev. Proc. 67-33, 1967-2 C.B. 659; see also Rev. Rul. 81-277, 1981-2 C.B. 14 (treating buyer's recovery of damages from contractor for additional construction costs to correct construction defects as return of capital).

The litigation between Taxpayer and Defendant, including the complaint, jury instructions and verdict, and the opinion of the Trial Court judge, consistently reflect that Defendant tortiously interfered with Taxpayer's acquisition of Target Sub and Other Target Assets and that Taxpayer's cost to acquire these assets increased as a result of Defendant's tortious interference. Moreover, the Trial Court calculated damages based on the \$Z increase in the purchase price for Target Sub and Other Target Assets that was caused by Defendant's tortious interference. Thus, Taxpayer's lawsuit was directly related to the cost of Taxpayer's investment in Target Sub and Other Target Assets and Taxpayer's recovery should be treated as a restoration of the \$Z of additional capital that Taxpayer invested to complete the acquisition at the increased price.

Arrowsmith v. Commissioner, 344 U.S. 6 (1952), also is instructive in determining the tax treatment of Taxpayer's recovery. *Arrowsmith* involved the 1937 liquidation of a corporation by two taxpayers with equal stock ownership. The corporation had made all distributions by 1940 and the taxpayers properly reported the profits obtained from the distributions as capital gains. In 1944, a judgment was rendered against the corporation. The two taxpayers, as transferees of the corporation's assets, were required to pay the judgment for the corporation. The taxpayers argued that because each taxable year stands on its own under the annual accounting principle, they were entitled to an ordinary business deduction for their payment of the judgment in 1944. This view was rejected by the Court, however, which held that the loss was capital because the taxpayers' liability arose from the corporation's liquidation proceedings and thus should be treated in the same manner as the liquidation proceeds they received.

Thus, under *Arrowsmith*, when a subsequent event is so integrally related to a prior event that the events are in effect part of the same transaction, the tax consequences of the subsequent event should be determined by reference to the prior event. See *Breslar v. Commissioner*, 65 T.C. 182 (1975), *acq.* 1976-2 C.B. 1 (applying *Arrowsmith* in characterizing litigation recovery related to loss on sale of section 1231 property); *Freedom Newspapers v. Commissioner*, T.C. Memo. 1977-429 (third party broker's payment to taxpayer relating to prior newspaper acquisition treated as reduction in purchase price); *cf. Seagate Technology, Inc. v. Commissioner*, T.C. Memo. 2000-361 (sale of restricted stock received as payment for assets following expiration of lockup period not integrally related to taxpayer's sale of assets).

Based on the facts, representations, and the relevant law as set forth above, we rule that the recovery of \$Z from Defendant is to be treated as a nontaxable return of capital to the extent of Taxpayer's adjusted basis in Holding Corp, Acquisition Corp II and Acquisition Corp III.

CAVEATS:

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. In particular, no opinion is expressed or implied as to the taxable year in which the Taxpayer recognizes receipt of the recovery under its method of accounting or the character of any income that the Taxpayer recognizes because the amount of the recovery attributable to Taxpayer's investment in Holding Corp, Acquisition Corp II or Acquisition Corp III exceeds Taxpayer's adjusted basis.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides

that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Michael J. Montemurro
Branch Chief
Office of Associate Chief Counsel (Income Tax
& Accounting)

Enclosure:

Copy for § 6110 purposes

cc: